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98TH CONGRESS, 1st Session } SENATE { REPORT No. 98-263

COORDINATION OF MONETARY AND FISCAL POLICIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

[To accompany S. Con. Res. 78]

A REPORT

together with

ADDITIONAL VIEWS

OCTOBER 5 (legislative day, OCTOBER 3), 1983.—Ordered to be printed

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Mr. GARN, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

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REPORT TO ACCOMPANY SENATE CONCURRENT RESOLUTION 73

Section 6 of House Concurrent Resolution 91, the First Concurrent Budget Resolution for fiscal year 1984, expressed concern over the implications of the large projected budget deficits for monetary policy, and requested that the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Banking, Finance, and Urban Affairs report to their respective bodies a resolution expressing the sense of the Congress as to the coordination of monetary and fiscal policy, the information required to implement the appropriate monetary policy, and such other matters as the Banking Committees deemed appropriate.

On July 21, 1983, the Committee on Banking, Housing, and Urban Affairs held hearings on this subject in conjunction with the hearings on this year's Second Monetary Policy Report (S. Rept. 98-227). Witnesses were: Federal Reserve Board Chairman Paul A. Volcker; Martin Feldstein, Chairman of the President's Council of Economic Advisers; Beryl Sprinkel, Under Secretary for Monetary Affairs of the Department of the Treasury; Alan Blinder, Professor of Economics, Princeton University; and A. James Meigs, Senior Vice President and Chief Economist, First Interstate Bank of California.

A further hearing was held before the Subcommittee on Economic Policy on July 28, 1983. Senator Daniel P. Moynihan and Federal Reserve Board Chairman Volcker were the witnesses at this second hearing.

THE MONETARY POLICY ENVIRONMENT

The concern which led to the incorporation into this year's First Concurrent Budget Resolution of the request that the Banking Committees consider the coordination of monetary and fiscal policies was created by the very large budget deficits which that Resolution projects; $179 billion in fiscal 1984, $161 billion in fiscal year 1985, and $131 billion in fiscal 1986. Deficits of this order of magnitude raise a number of fears:

> Can the Federal Reserve continue to promote lower interest rates when faced with very large government borrowing demands?
>
> Is fiscal policy placing an unrealistic burden on monetary policy to continue the successes that have been achieved in the last two years in reducing the rate of inflation?
>
> Will the Treasury's borrowing demands place pressure on the Federal Reserve to "accommodate" such borrowing by monetizing an excessive amount of the new public debt?

It should be noted that there is no disagreement over the need for or desirability of lower interest rates. The questions which the fiscal policy embodied in House Concurrent Resolution 91 raises are over what monetary policy will achieve lower interest rates, if such are achievable, given the federal government's large borrowing demands.

Since 1981, the Federal Reserve Board has achieved a significant reduction in interest rates. The three-month Treasury bill rate declined from 14.62 percent at the end of 1980 to 9.07 percent in mid-July 1983, This decline has been attributable principally to a decline in the expected rate of inflation, which in turn has been due to a more moderate rate of growth in the money supply, at least until mid–1982. The decline in normal interest rates has not, however, been accompanied by a corresponding decline in real rates, at least if current inflation rates are taken as approximate indicators of the expected future rate of inflation. Even if further progress is made in lowering nominal rates by adhering to an anti-inflationary monetary policy, there are fears that government credit demands could keep real rates excessively high.

The Senate Committee on Banking, Housing, and Urban Affairs reported to the Congress on these and related issues in its Second Monetary Policy Report for 1983, Senate Report 98–227.

THE RELATIONSHIP BETWEEN MONEY SUPPLY GROWTH AND INTEREST RATES

The Committee heard testimony from all witnesses on the relationship between changes in the money supply and interest rates. There was a strong degree of concurrence among the panelists, subject to concerns about the changing velocity of money (addressed below). Thus, Council of Economic Advisers Chairman Feldstein stated: "Experience shows that faster money supply growth leads to higher inflation and higher interest rates."
and further:

> Although the Federal Reserve could temporarily lower short-term interest rates by explicitly adopting a policy of rapid expansion of the money stock, this would subsequently lead to higher rates of inflation and higher market rates of interest.

Thus, an increased rate of money supply growth could lead to a temporary drop in interest rates but, especially in an environment in which borrowers and lenders had become sensitized to the possibility of inflation, would ultimately generate inflationary expectations, and lead to an increase in nominal rates of interest.

In such an environment it is fruitless for the Federal Reserve to attempt to "target" interest rates or gross national product. Any effect which the Federal Reserve could have on gross national product would occur strictly through its effects on the price level, and attempts to lower the real rate of interest by expanding the money supply would be self-defeating, and lead to increases in the nominal interest rates.

Treasury Under Secretary Sprinkel testified:

> A central bank has no power to control real economic variables over the long run. Therefore real variables—such as real GNP growth, real interest rates, the unemployment rate—are also not viable targets for monetary policy actions. The only thing that a central bank can do over the long run is to assure price stability; that is accomplished by providing for an appropriate rate of monetary expansion.

THE VELOCITY OF MONEY

Numerous concerns were expressed over the instability of the velocity of money, and its implications for monetary policy. Since the end of 1981, velocity has fallen sharply from its prevailing level, reversing its long-term trend. This decline in velocity has been appealed to by many both as a reason why the rapid money stock growth in the second half of 1982 has not reignited inflation, and as a justification for the use of judgment rather than automaticity in the conduct of monetary policy. Professor Blinder testified: ". . . he who targets on the growth rate of money when velocity is behaving erratically is looking for trouble."

At the same time, concern was expressed that the deviation of velocity from its historical trend was only temporary, and that when the historical pattern reasserted itself, that recent monetary policy could be dangerously inflationary.

Much of the apparent decline in the velocity of money was attributed to the structural change which has taken place in recent months in financial markets, most importantly, the creation of Money Market Demand Accounts, and the introduction of NOW accounts prior to that. But these factors appear to be about played out for the time being, and other factors must be searched for an explanation of the behavior of velocity.

Under Secretary Sprinkel voiced particularly strong concerns about over-reliance on assumptions that the value of the velocity of money had changed in anything other than a short-term way. Much, though not all, of the decline in its value he attributed to the recession. In addition, Mr. Sprinkel raised fears that monetary policy itself could be resulting in a reduced velocity of money, as sudden increases in the money stock take time to operate on nominal GNP:

> An acceleration of money growth in one quarter cannot be expected to induce higher nominal GNP growth in the same quarter; it takes two or three quarters for an increase in

> money growth to stimulate spending and induce an associated increase in nominal GNP growth. Since a large increase in the rate of money growth causes no immediate increase in nominal GNP, and velocity growth is simply the ratio of nominal GNP growth to money growth, the immediate effect of accelerated money growth is likely to be a contemporaneous decline in velocity.

Thus, Under Secretary Sprinkel was concerned that the rapid money stock growth of the second half of 1982 and early 1983 was itself destabilizing the value of velocity. If the change in the velocity of money is indeed temporary, then the ultimate result of the rapid money stock growth will be higher inflation and higher interest rates. Under these circumstances, it would be desirable to moderate the swings in the rate of money stock growth.

FEDERAL GOVERNMENT CREDIT DEMANDS

The Federal Reserve's policy of targeting monetary policy with reference to monetary and credit aggregates should be continued. It would be helpful to the committee, however, to have additional information concerning the distribution of credit, and especially the effects of government borrowing demands on the credit markets. These demands are the principal source of fears that private investment demand will be "crowded out" of the credit markets, resulting in a failure to sustain the current economic recovery in the short run, and in a failure to add to the nation's productive capital stock over the longer run.

The Committee felt it would be helpful to have information on the relative size of government and private credit demands, not only for its own sake, but also to highlight the continuing strains being placed on credit markets by the large federal government deficits. It has been estimated that federal borrowing accounts for 65% of all credit market activity and it is important that these demands receive continuing Congressional attention.

CONCLUSION

In general, the Committee felt that it was important for the Federal Reserve to resist calls for an inflationary monetary policy, despite the fact that the large budget deficits projected by House Concurrent Resolution 91 would certainly prompt such calls. These deficits, however, are not reason for the Federal Reserve to modify its policies. Current economic problems lie more with fiscal policy than with monetary policy. In particular, the Federal Reserve should not attempt to ease the Treasury's borrowing costs by a short-sighted expansion of the money supply. There is no simple rule which specifies optimal monetary policy for different budgetary situations. In this sense, a mechanical coordination of monetary and fiscal policies is impossible.

Instead, the Federal Reserve should continue to pursue its goals of economic growth with stable prices, exercising such judgment as is necessary to reflect changes in the velocity of money. The Committee

was concerned that wide fluctuations in the rate of money supply growth could be destabilizing. Now that some of the developments in financial markets that led to such swings in the past appear to have abated, it hopes that the money supply will adopt a more stable growth path.

Senators voting in favor of the Resolution: Senator Garn, Senator Tower, Senator Heinz, Senator D'Amato, Senator Gorton, Senator Hawkins, Senator Mattingly, Senator Trible, Senator Hecht, Senator Proxmire.

Senators voting against the Resolution: Senator Cranston, Senator Riegle, Senator Sarbanes, Senator Dodd, Senator Dixon, Senator Sasser, Senator Lautenberg.

ADDITIONAL VIEWS OF MESSRS. CRANSTON, RIEGLE, SARBANES, SASSER, AND LAUTENBERG

We believe the Resolution on Monetary Policy reported by the Committee sends the wrong message to the Federal Reserve Board. It fails to give the FED a clear directive that it should place first priority on achieving economic growth and recovery and lower real interest rates. Instead, it urges the FED to follow a policy of continuing to reduce the rate of growth in the monetary aggregates. It further recommends that interest rates or other economic variables not be used as targets in setting monetary policy. In short, the Resolution attempts to enshrine the doctrine of monetarism at the very time when monetarism has been severely discredited as a reliable guide to monetary policy.

Fortunately, the Federal Reserve has proven to be less rigid than its monetarist critics. While under strong pressure from the Congress, the Board relaxed its money growth targets in July of 1982. Interest rates promptly fell from their crushing levels, thereby paving the way for the modest economic recovery which began early in 1983. Had the FED attempted to maintain its original targets, the economy would have continued its downward spiral while the international financial system would have been threatened with an imminent collapse. We see no need for the Federal Reserve to return to the discredited policies that pushed the economy to the brink of economic and financial disaster.

As we assess the economic outlook over the next year, we believe the significant danger is not a resurgence of inflation, but a collapse of the modest recovery now underway. Despite the fears of some Administration economists that the economy is growing too fast, the recovery is still weak by historical standards. Real growth during the first three quarters of 1983 will average about 6.4 percent, well below the average 7.9 percent growth rate realized during comparable periods in the last seven business cycle recoveries. We did better in five of those last seven recoveries. Moreover, statistical studies of these recovery periods show there is no positive relationship between the rate of recovery and subsequent increases in inflation.

To be sure, all recoveries tended to increase inflation as the economy reached fuller employment, but the amount of inflation increase was not affected by how fast the economic recovery proceeded. Moreover, the amount of inflation increase attributable to economic growth was quite small—about a one percentage point increase in the inflation rate for every 10 percentage point increase in real growth as measured from the cyclical trough. A 10 percentage point increase in real economic output in one year would cut unemployment by 1.4 percentage points and put over 1.5 million Americans back to work.

There is another reason why we believe the Federal Reserve should follow a growth-oriented policy. The evidence from previous recoveries indicates that the length of the recovery was significantly influenced

by the rate of growth during its early stages. Vigorous growth in the first few quarters of a recovery tended to produce a longer, sustained recovery period. When initial growth was anemic, the recovery tended to be short-lived. For example, the five previous recoveries with the highest growth rate during the first three quarters resulted in an average recovery period of 54 months, compared to 24 months for the two recoveries with the lowest rate of initial growth.

Unfortunately, our present monetary policy reporting procedures do not focus attention on the central issues of economic policy. The Congress has no real idea whether the Federal Reserve is pursuing a high-growth or a low-growth economic policy. Instead, monetary policy oversight hearings tend to be shrouded in the arcane language of monetary technicians—M1, M2, velocity, etc. These concepts are becoming increasingly suspect as reliable guides to policy, especially with thhe rapid financial deregulation that has distorted the meaning of the monetary aggregates. Moreover, sizeable and unpredictable shifts in the demand for cash balances make it extremely difficult to establish meaningful monetary targets. As a result, the Federal Reserve is left free to conduct policy largely on its own terms with less and less accountability to the Congress.

We believe the Federal Reserve should follow a balanced growth-oriented policy over the next year which takes fully into account the effects of monetary and credit conditions on real economic performance. Instead of fixing on arbitrary numerical targets for money growth as its sole objective, we believe the FED should also establish growth targets for the real economy and help to achieve those targets through monetary policy. Should the recovery begin to falter, this would provide a built-in signal to the FED that it was time to adopt a more accommodative policy in order to meet its growth objectives for the economy. Such an approach would provide the Congress and the public with a much clearer picture of where the Federal Reserve is heading and how it plans to get there.

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